QFINANCE

Understanding Reputation Risk and Its Importance

by Jenny Rayner

Executive Summary

- Reputation is a critical intangible asset; it is an indicator of past performance and future prospects.
- Reputation is based on stakeholders' perception of whether their experience of a business matches their expectations.
- Knowing your major stakeholders, how they perceive you, and what they expect of you is vital in managing reputation risk.
- Everyone working for an organization bears some responsibility for upholding its reputation.
- Reputation risk is anything that could *impact* reputation—either negatively (threats) or positively (opportunities).
- Risks to reputation should be integrated into the business's enterprise risk management (ERM) framework so that they receive attention at the right level and appropriate actions are taken to manage them.

Introduction

Reputation is the single most valuable asset of most businesses today—albeit an intangible one. A 2007 global survey[1] rated damage to reputation as the top risk, although half the respondents admitted that they were not prepared for it. Hard-earned reputations can be surprisingly fragile in the globalized, technologically interconnected 21st century. The trust and confidence that underpin them can be irrevocably damaged by a momentary lapse of judgment or an inadvertent remark.

That is why understanding reputation risk has become a key focus for businesses in all sectors. It is now recognized that reputation risks need to be managed as actively and rigorously as other more quantifiable and tangible risks.

Reputation and Its Value

Reputation is an accumulation of perceptions and opinions about an organization that reside in the consciousness of its stakeholders.

An organization will enjoy a good reputation when its behavior and performance consistently meet or exceed the expectations of its stakeholders. Reputation will diminish if an organization's words and deeds are perceived as failing to meet stakeholder expectations, as illustrated by the reputation equation below.[2]

Reputation # Experience = Expectations

Reputation has intrinsic current value as an intangible asset. Although reputation will not appear as a discrete balance sheet item, it represents a significant proportion of the difference between a business's market and book values (less any quantifiable intangibles such as licenses and trademarks). Since intangibles usually represent over 70% of market value, reputation is often a business's single greatest asset.

Reputation also plays a pivotal role in a business's future value by influencing stakeholder behavior and, hence, future earnings potential and prospects. A good or bad reputation can affect stakeholder decisions to maintain or relinquish their stake—be they investors, customers, suppliers, or employees. The "corporate halo" effect of a reputable business can help to differentiate products in a highly competitive sector, may allow premium pricing, and can be the ultimate deciding factor for a prospective purchaser of services. A strong reputation can help to attract and retain high-quality employees and can deter new competitors by acting as a barrier to market entry. Reputation can also shape the attitude of regulators, pressure groups, and the media towards a business and can affect its cost of capital.

Perhaps the greatest benefit of a good reputation is the buffer of goodwill it provides, which can enable a business to withstand future shocks. This “reputational capital,” or “reputation equity,” underpins stakeholder trust and confidence and can persuade stakeholders to give a business the benefit of the doubt and a second chance when the inevitable unforeseen crisis strikes.

Defining Reputation Risk

Reputation risk should be regarded as a generic term embracing the risks, from any source, that can *impact* reputation, and not as a category of risk in its own right. Regulatory noncompliance, loss of customer data, unethical employee behavior, or an unexpected profit warning can all damage reputation and stakeholder confidence.

Reputation risk is not only about downside threats, but also about upside opportunities. Climate change, for example, is a potential business threat, but many firms have spotted and exploited the flip-side opportunity for competitive advantage by developing green technologies and promoting themselves as environmentally friendly, thereby enhancing their reputation.

Reputation risk can therefore be defined as:

“Any action, event or situation that could adversely or beneficially impact an organization’s reputation.”

Identifying Reputation Risks

The most crucial stage of the reputation risk management process is *identifying* the factors that could impact reputation. Risks have to be recognized and understood before they can be managed. Considering the seven drivers of reputation is a useful starting point, as these are also fertile sources of threats and opportunity to reputation (see figure above.[3])

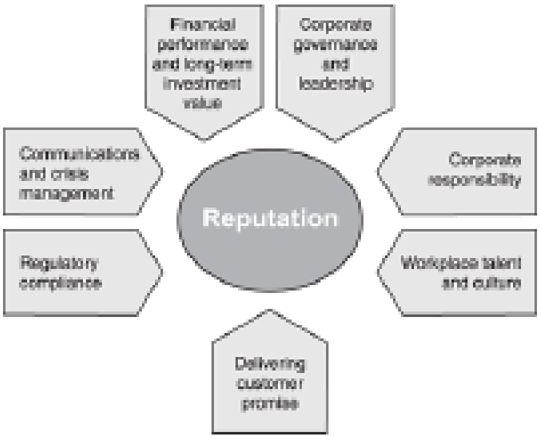

Figure 1.The seven drivers of reputation

Businesses should consider not only the risks under their direct control, but also risks in the “extended enterprise” relating to suppliers, subcontractors, business partners, advisers, and other stakeholders. Could the values, business practices, or activities of its partners expose the business to reputation risk by association?

One way of approaching this is to consider the expectations of each major stakeholder group against the drivers of business reputation to develop a “heat map” of potential trouble spots and zones of opportunity. Major mismatches between expectations and experience can be analyzed to highlight areas where action is needed to bridge the gaps.

Asking the following questions may also help to uncover reputation risks:

- What newspaper headline about your business would you least (or most) like to see? What could trigger this?

- What could threaten your core business values or your license to operate? Such risks can seriously damage reputation and lead to an irreversible loss of stakeholder confidence.
- Could there be collateral risk arising from the activities of another player in your sector? If so, the reputation of your own business may be vulnerable and come under intense stakeholder scrutiny.
- Could reputation risk exposure arise from an acquisition, merger, or other portfolio change? A mismatch of values, ethos, culture, and standards resulting in inappropriate behavior could seriously damage reputation. Conversely, if the acquisition target enjoys a superior reputation, it could provide a competitive edge.

Evaluating, Responding To, Monitoring, and Reporting Risks

Once risks to reputation have been identified, they can be evaluated, appropriate risk responses developed, and the risks monitored and reported.

Risks to reputation can be *evaluated* in the usual way by considering the likelihood of the risk occurring and the impact if it does. The reputational impact of such risks should be considered explicitly, alongside financial or other impacts. This can be done by the use of a word model which explains reputational impact in a way that is relevant and meaningful for a given business. The table below provides an example of a four-point reputation impact scale that caters for both threats and opportunities.

Table 1

Low	**Moderate**	**High**	**Very high**
Local complaint or recognition Minimal change in stakeholder confidence Impact lasting less than one month	Local media coverage Moderate change in stakeholder confidence Impact lasting between one and three months	National media coverage Significant change in stakeholder confidence Impact lasting more than three months Attracts regulator attention or comment	National headline/ international media coverage Dramatic change in stakeholder confidence Impact lasting more than 12 months or irreversible Public censure or accolade by regulators

In assessing reputational impact, the view of relevant stakeholders should be considered to ensure that the impact is not underestimated. That is why understanding stakeholders and what they regard as current and emerging major issues lies at the heart of reputation risk management.

Reputational impact can sometimes be quantified in monetary terms—for example, expected reduced income resulting from loss of customers or license to operate; or impact on share price or on brand value. The true ultimate impact can be difficult to estimate as the immediate consequence may be only a relatively small financial penalty (for example, a fine for pollution). However, the event may, over time, have an insidious effect which erodes the business's reputation (for example, because of a perception that the business is not concerned about the environment).

Response plans should be developed to manage the more significant risks that present unacceptable exposure to the business. The gap between experience and expectation can be bridged by improving the business's performance or behavior and/or by influencing stakeholder expectations so they are more closely aligned with what the business can realistically deliver. As reputation is based on stakeholder perception, focused and clear communication to stakeholders is vital so that their perception will accurately reflect business reality.

A business may have done everything possible to anticipate and guard against reputational threats, but if a crisis strikes and the business response is inappropriate, its reputation may still end up in tatters. Having an effective and well-rehearsed generic crisis management plan that can be quickly adapted and implemented to suit specific circumstances is therefore a key component of an effective reputation risk management strategy.

Once risks to reputation have been identified and responses agreed and implemented, the risks can be regularly *monitored* by management to ensure that responses are having the desired effect. Finally, the up-

to-date status of the risks should be *reported* at the right level to inform decision-making and enable external disclosure to stakeholders.

Roles and Responsibilities

The board of a business is the ultimate custodian of a business's reputation. However, managing reputation risk successfully requires a team effort across the business from executive and nonexecutive directors, senior and middle managers, public relations staff, risk and audit professionals, and key business partners.

Everyone employed by and indirectly working for a business should be expected to uphold the business's values and bear some responsibility for spotting emerging risks that could impact reputation. The telltale signs of an imminent crisis are often missed because personnel are not risk-aware: a spate of customer complaints, safety near-misses or supplier nonconformances, a sudden rise in employee turnover, or pressure group activity. These can act as crucial early warning indicators which allow a business to take corrective action and avert disaster.

Case Study

Citigroup

In September 2004 the Financial Services Agency (FSA), Japan's bank regulator, ordered Citigroup to close its private banking business in the country following "serious violations" of Japanese banking laws. An FSA investigation found that inadequate local internal controls and lack of oversight from the United States had allowed large profits to be "amassed illegally." The bank had failed to prevent suspected money laundering and had misled customers about investment risk. The punishment meted out by the FSA was particularly severe as a previous inspection in 2001 had exposed similar compliance weaknesses, which Citigroup had not corrected.

Citigroup's then chief executive, Charles Prince, visited Japan in October 2004 in an attempt to repair the company's tarnished image. Bowing, he apologized for the activities of his senior staff, saying that they had put "short-term profits ahead of the bank's long-term reputation." He pledged to improve oversight, change the management structure, increase employee training on local regulations, and set up an independent committee to monitor progress. He said: "Under my leadership, lack of compliance and inappropriate behavior simply will not be tolerated and we will take direct action to ensure that proper standards are upheld and that these problems do not reoccur."

That same month French retailer Carrefour fired Citigroup as a financial adviser on the sale of its Japanese operations to prevent its own reputation from being tarnished by association.

Conclusion

A good reputation hinges on a business living the values it claims to espouse and delivering consistently on the promise to its stakeholders. Being "authentic," being "the real thing," has never been so important. Pursuing short-term gain at the expense of long-term business reputation and stakeholder interests is no longer acceptable practice.

Successfully managing reputation risk is both an inside-out and an outside-in challenge. The inside-out component requires business leaders to establish an appropriate vision, values, and strategic goals that will guide actions and behaviors throughout the organization. The outside-in component requires the business to continuously scan the external environment and canvass stakeholder opinion to ensure it is on a track that will secure the continuing support, trust, and confidence of its stakeholders.

Active and systematic management of the risks to reputation can help to ensure that perception is aligned with reality and that stakeholder experience matches expectations. Only in this way can a business build, safeguard, and enhance a reputation that will be sustainable in the long term.

Making It Happen

The key components of reputation risk management are:

- Clear and well-communicated business vision, values, and strategy that set the right ethical and stakeholder-aware tone for the business.
- Supporting policies and codes of conduct that guide employee behavior and decision-making so that goals are achieved in accordance with business values.
- Extension of the business's values and relevant policies to key partners in the supply chain.
- Dialogue and engagement to track the changing perceptions, requirements, and expectations of major stakeholders continuously.
- An effective enterprise-wide risk management system that identifies, assesses, responds to, monitors, and reports on threats and opportunities to reputation.
- A culture in which employees are risk-aware, are encouraged to be vigilant, raise concerns, highlight opportunities, and act as reputational ambassadors for the business.
- Transparent communications that meet stakeholder needs and build trust and confidence.
- Robust and well-rehearsed crisis management arrangements.

More Info

Books:

- Atkins, Derek, Ian Bates, and Lyn Drennan. *Reputational Risk: Responsibility Without Control? A Question of Trust*. London: Financial World Publishing, 2006.
- Fombrun, Charles J., and Cees B. M. van Riel. *Fame and Fortune: How Successful Companies Build Winning Reputations*. Upper Saddle River, NJ: FT Prentice Hall, 2003.
- Larkin, Judy. *Strategic Reputation Risk Management*. Basingstoke, UK: Palgrave MacMillan, 2003.
- Rayner, Jenny. *Managing Reputational Risk: Curbing Threats, Leveraging Opportunities*. Chichester, UK: Wiley, 2003.

Article:

- See articles in *The Geneva Papers on Risk and Insurance Issues and Practice* 31:3 (July 2006). Find issue in “Archive” at: www.palgrave-journals.com/gpp

Reports:

- Coutts and Company. “Face value: Your reputation as a business asset.” London: Coutts and Company, 2008.
- Economist Intelligence Unit. “Reputation: Risk of risks.” White paper, 2005.
- Resnick, Jeffrey T. “Reputational risk management: A framework for safeguarding your organization's primary intangible asset.” Opinion Research Corporation, 2006. Online at: www.carma.com/Reputational_Risk_White_Paper.pdf

Websites:

- The John Madejski Centre for Reputation, Henley Business School at the University of Reading—search on “Madejski” at: www.henley.reading.ac.uk
- Reputation Institute: www.reputationinstitute.com

Notes

[1] Aon's Global Risk Management Survey, based on responses from 320 organizations in 29 countries.

[2] Oonagh Mary Harpur in Chapter B4 of *Corporate Social Responsibility Monitor*. London: Gee Publishing, 2002.

[3] Rayner, 2003.

See Also

Best Practice

- CSR: More than PR, Pursuing Competitive Advantage in the Long Run
- Fraud: Minimizing the Impact on Corporate Image
- Internal Auditors and Enterprise Risk Management
- Managing 21st Century Finances
- The Value and Management of Intellectual Property, Intangible Assets, and Goodwill

Checklists

- Defining Corporate Governance: Its Aims, Goals, and Responsibilities
- Understanding Crisis Management

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